Rates/FX Strategy

(Not so) big in Japan

AUTHORS

Chiara Cremonesi
Senior Rates Strategist
chiara.cremonesi@animasgr.it

Valerio Ceoloni
Senior FX/EM Strategist
valerio.ceoloni@animasgr.it

The broad sell-off in Japanese Government Bonds (JGBs) in mid-May triggered renewed concerns about Japan's financial stability, debt sustainability, and the potential for a new wave of capital repatriation that could disrupt foreign bond markets.

We believe these fears are overstated for the following reasons:

1) Japan's financial stability is not at risk.

2) Japan's debt sustainability remains sound, supported by several factors, including the large share of domestic ownership.

3) The conditions for large-scale capital repatriation from Japan are not currently in place.

Against this backdrop, we see no compelling case for JGB yields spiralling out of control.

JGBs back in the spotlight

The sharp sell-off at the long end of the JGB curve and the steepening of the 10s/30s spread in mid-May have raised investor concerns about potential spillovers into other bond markets, particularly USTs, where Japanese investors are the largest foreign holders. We identify three key factors that may have contributed to fears that Japan's financial system and government debt markets could spiral out of control:

1. Concerns about financial stability in Japan

In mid-May, concerns about the impact of the sell-off in extra-long JGBs on the financial health of life insurers triggered speculation about potential fire sales of both JGBs and foreign bonds by these investors.

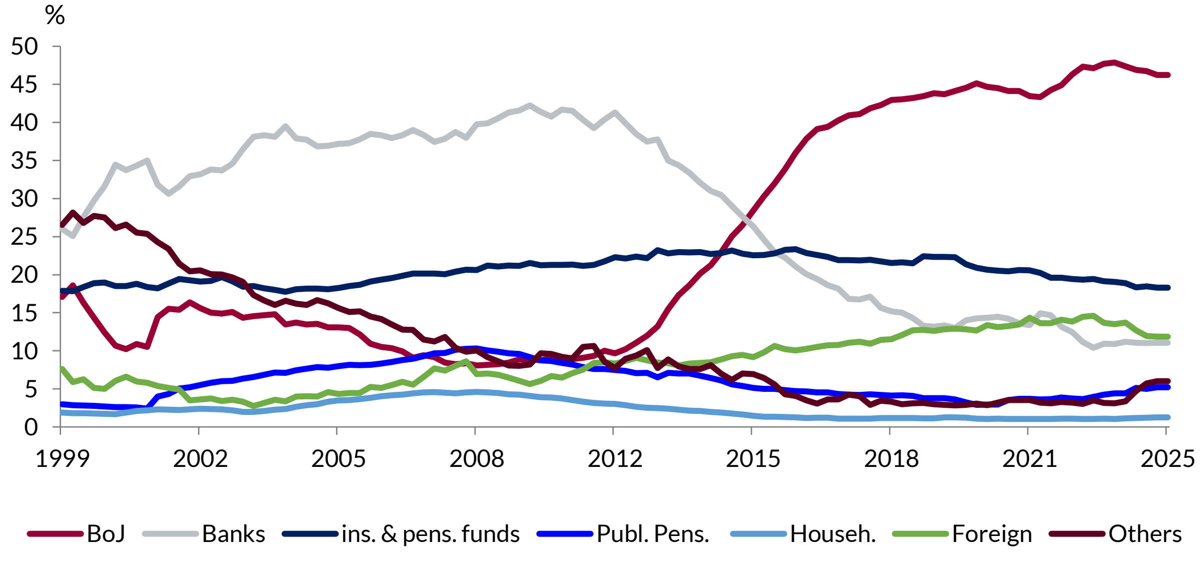
As shown in Figure 1, life insurers and pension funds hold approximately 18% of total Japanese government debt, equivalent to JPY 220 trillion (USD 1.52 trillion), making them the second-largest holders of domestic debt and a strategically important sector for absorbing JGB issuance.

In addition, life insurers hold around JPY 100 trillion (USD 691 billion) in foreign securities (Figure 2), ranking as the third-largest holders of foreign assets among Japanese investors and representing a significant presence in global bond markets, particularly in U.S. Treasuries, which account for a substantial portion of these holdings.

Taken together, life insurers and pension funds in Japan hold more than 50% of their assets in debt securities (both domestic and foreign), quite a high portion considering that EA insurance and pension funds hold around 34% of their total assets in debt securities.

Figure 1

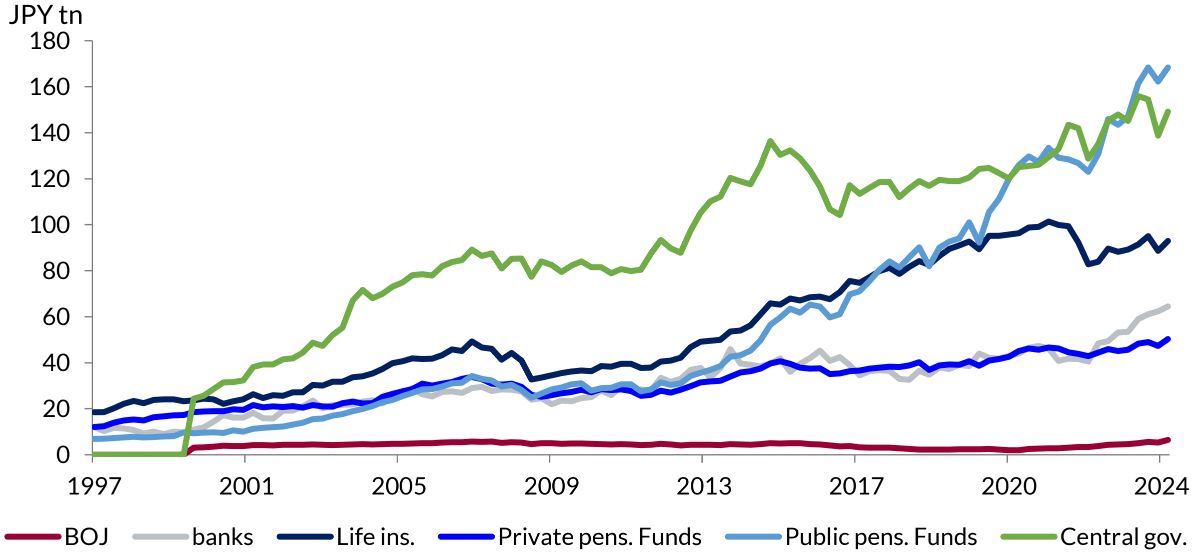
Major holders of JGBs (% of total government debt)



Source: Bloomberg, Japan MOF, ANIMA Research

Figure 2

Holding of foreign securities by different categories of Japanese investors



Source: Bloomberg, Japan MOF, ANIMA Research

2. Concerns about debt sustainability

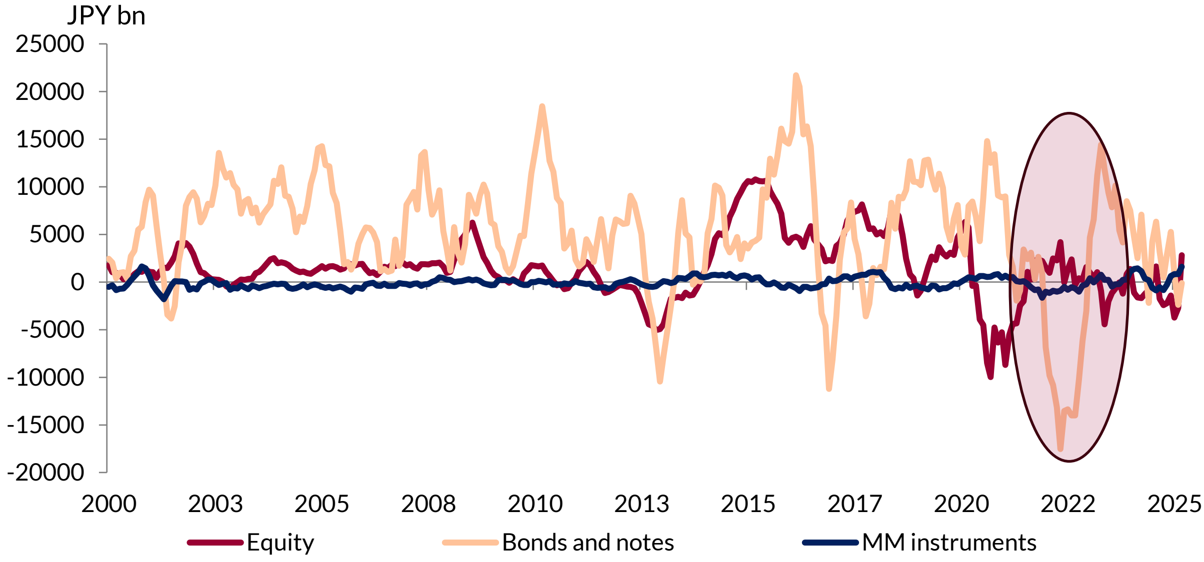
A weak result at a 30Y JGB auction in mid-May triggered renewed investor concerns about Japan's debt sustainability, further exacerbated by the fact that the major holders of JGBs, the BoJ, is reducing its holdings via QT and that the cost of debt is rising, given the current BoJ hiking cycle. Concerns on JGBs market stability reverberated through other bond markets, given that debt sustainability has re-emerged as a key concern across developed countries recently.

3. Concerns about capital repatriation by Japanese investors

Following the recent rise in JGB yields, concerns about capital repatriation by Japanese investors have resurfaced, with fears of a repeat of the mid-2022 episode, when Japanese investors abruptly and significantly reduced their holdings of foreign bonds (Figure 3).

Figure 3

Japanese Investors' Outward Investments (6M Rolling Sum)



Source: Bloomberg, Japan MOF, ANIMA Research

Our take: No need to panic

We believe that investor concerns about financial stability in Japan, debt sustainability and repatriation of capitals are overstated and while we acknowledge that some structural changes may be underway in the Japanese bond market, we expect these shifts to unfold in an orderly manner. Our view is supported by the following reasons:

1. Financial stability not challenged

Financial stability is not expected to be challenged in the short-term by the recent increase in long-term JGBs yields, for the following reasons:

1) Life insurers' liabilities and bonds are mostly valued at book value rather than marked to market. This approach minimizes the risk of valuation losses unless bonds are sold.

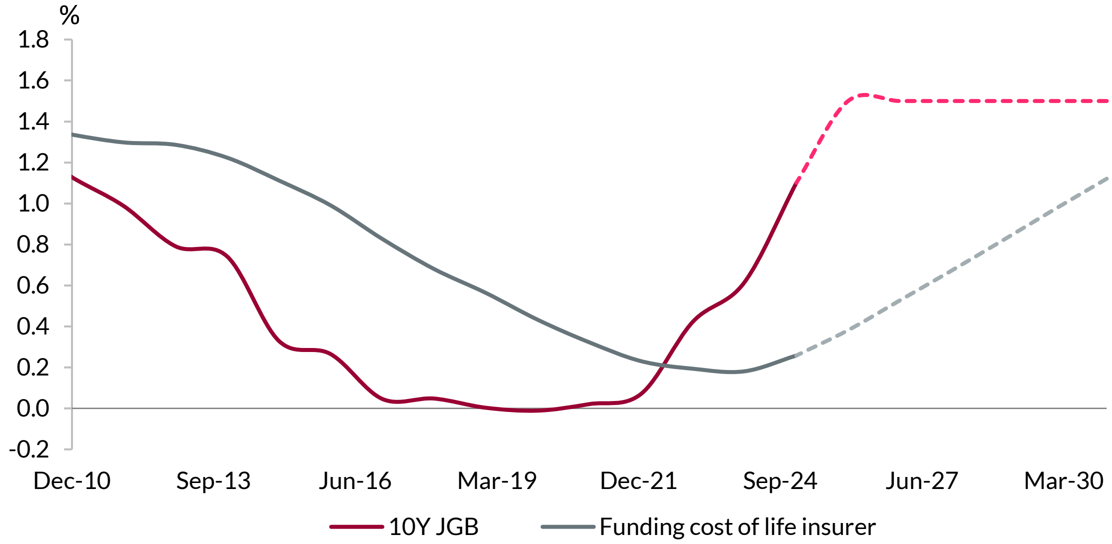
2) Life insurers' funding costs are based on the average yields of 10Y JGBs over the past 10 years, so any rise in costs will occur only very gradually (Figure 4).

3) While rising yields can affect life insurers' Economic Solvency Ratio (ESR) calculations, the overall impact is expected to be moderate. Increasing yields negatively affect ESR because assets and liabilities are marked to market, but higher interest rates simultaneously boost profits and capital, offsetting some of the impact.

4) Meanwhile, banks which mostly hold short- to medium-term JGBs and the corporate sector, which generally has low leverage, are expected to be only marginally affected by the increase in JGB yields.

Figure 4

Projected Evolution of Japanese Life Insurers' Funding Costs Assuming 10-Year JGB Yields Remain at 1.5% Through 2030



Source: Bloomberg, ANIMA Research

2. Debt sustainability is not a challenge for Japan

Despite having the highest public debt-to-GDP ratio among developed countries (237% in 2024), we believe concerns about Japan's debt sustainability are overstated, at least in the short-term, for the following reasons:

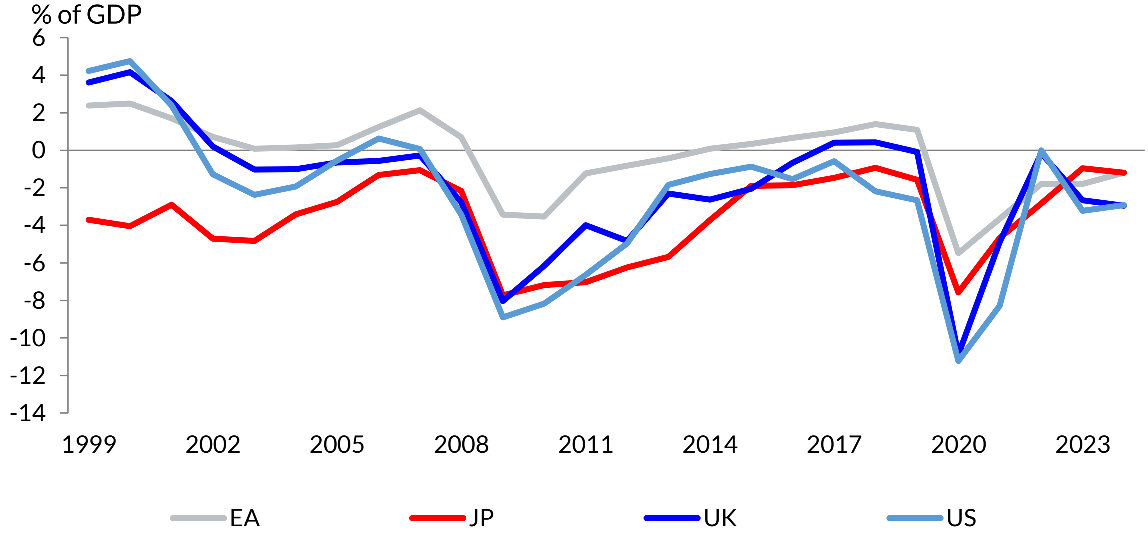
1) **Strong fiscal metrics:** Although Japan's primary balance remains in deficit, it is smaller than that of the UK and the U.S. and comparable to the Euro Area (Figure 5). Interest payments are also lower than those of the Euro Area, U.S., and UK, both as a percentage of GDP and government revenues (Figure 6). Moreover, Japan's government debt has an average maturity of 8.6 years, well above the G7 average of 7 years. Importantly, nearly 90% of government debt is held domestically, with almost 50% held by the BoJ.

2) **Moderate net government bond issuance:** Estimated at JPY 26 trillion this year, net government bond issuance is lower than last year but still represents more than 4% of 2024 GDP. Following weak results in super-long bond auctions, the Ministry of Finance has expressed willingness to adjust the average maturity of issuance to better align with demand conditions. Given Japan's already long average debt maturity, shortening issuance maturity should not pose significant issues.

3) **Bank of Japan's gradual QT approach:** The BoJ recently announced it will slow the pace of quantitative tightening, facilitating a smoother transition to a greater role for private investors.

Figure 5

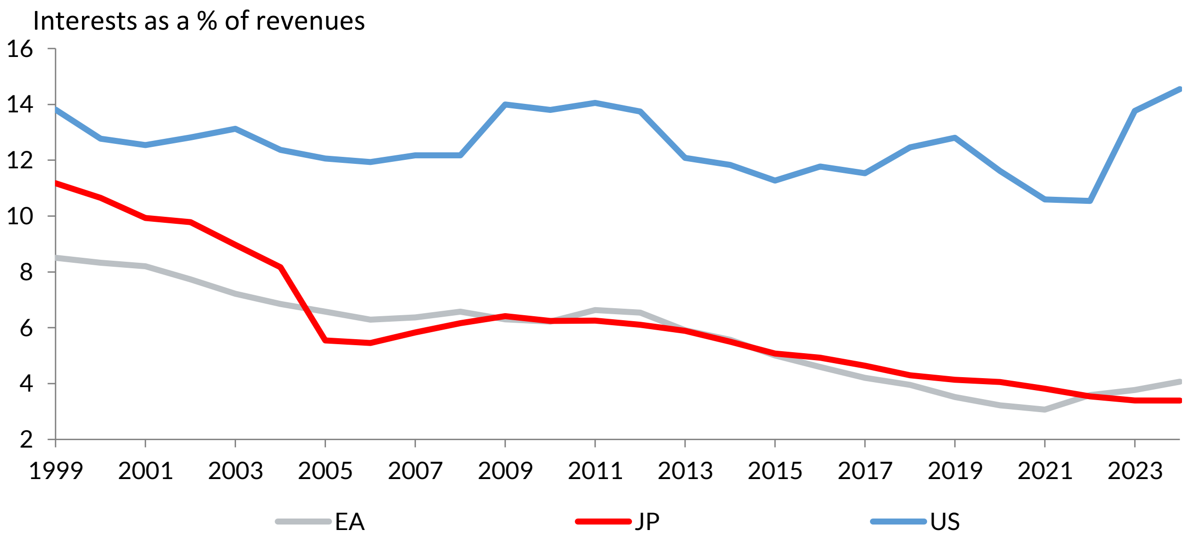
Primary balance is in deficit, but lower than in the US and the UK



Source: Bloomberg, Haver Analytics, EC, ANIMA Research

Figure 6

Primary balance is in deficit, but lower than in the US and the UK



Source: Bloomberg, Haver Analytics, EC, ANIMA Research

3. Conditions for disorderly repatriation are not met

We believe a sudden and disorderly repatriation of Japanese capital could occur only if three conditions are met simultaneously, as was the case in 2022 when Japanese investors repatriated capital en masse.

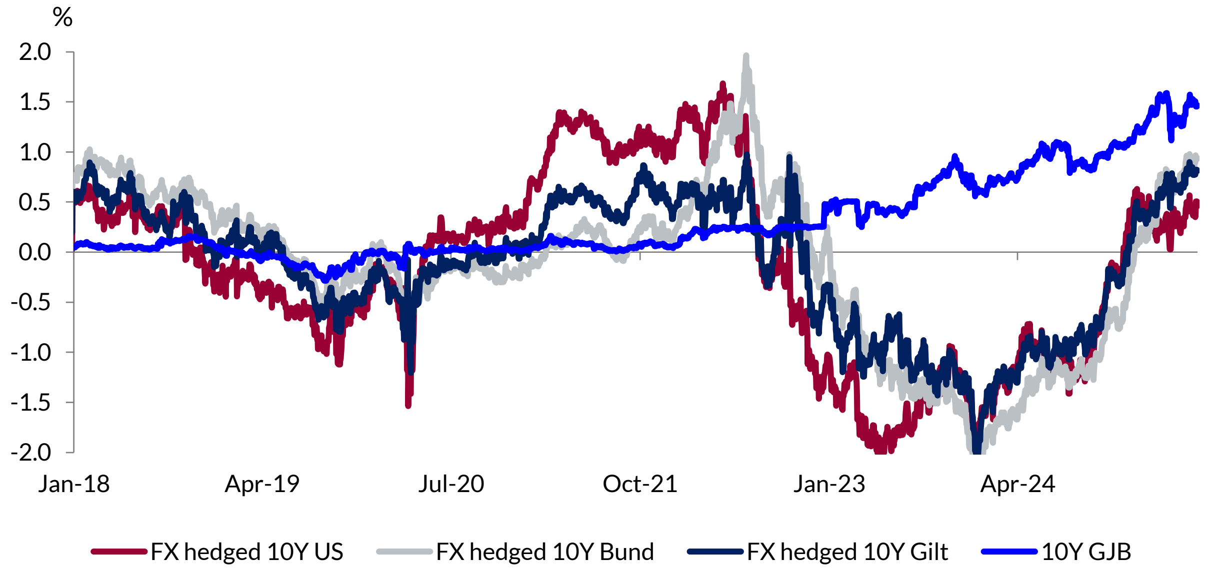
i. JGB yields are attractive compared to FX-hedged foreign bonds

An increase in Japanese yields makes investing in 10Y JGBs more attractive than in 10-year U.S. Treasuries, Bunds, and Gilts, after hedging for currency risk.

Figure 7 shows that 10Y JGB yields have been higher than currency-hedged 10Y UST, Bunds and Gilts since late 2022. However, this yield advantage carries a different significance today. Since the start of the Trump presidency, most Japanese investors in USTs have likely hedged their currency exposure. In contrast, in 2023 and 2024, many Japanese investors have taken exposure to foreign bonds without hedging for the currency risk.

Figure 7

JGBs are more attractive than FX-hedged foreign bonds



Source: Bloomberg, ANIMA Research

ii. The role of the currency: a feedback loop

An increase in Japanese yields that makes investing in 10Y JGBs more attractive than in 10-year U.S. Treasuries, Bunds, and Gilts, after hedging for currency risk.

A strong USD vis à vis the JPY influences capital repatriation decisions. Japanese investors prefer to repatriate funds from the US when the exchange rate favours the USD, either to benefit from currency gains, as happened in 2022, or to avoid potential irreversible depreciation of the USD and resulting losses. Conversely, repatriating during a period of a stronger yen is generally unprofitable.

Currency movements play a decisive role in triggering or halting repatriation flows. When the dollar appreciates, repatriation flows tend to accelerate, which then pushes the yen higher. This appreciation of the yen erases dollar gains, effectively closing the window of opportunity for further repatriation. This dynamic has been evident since March.

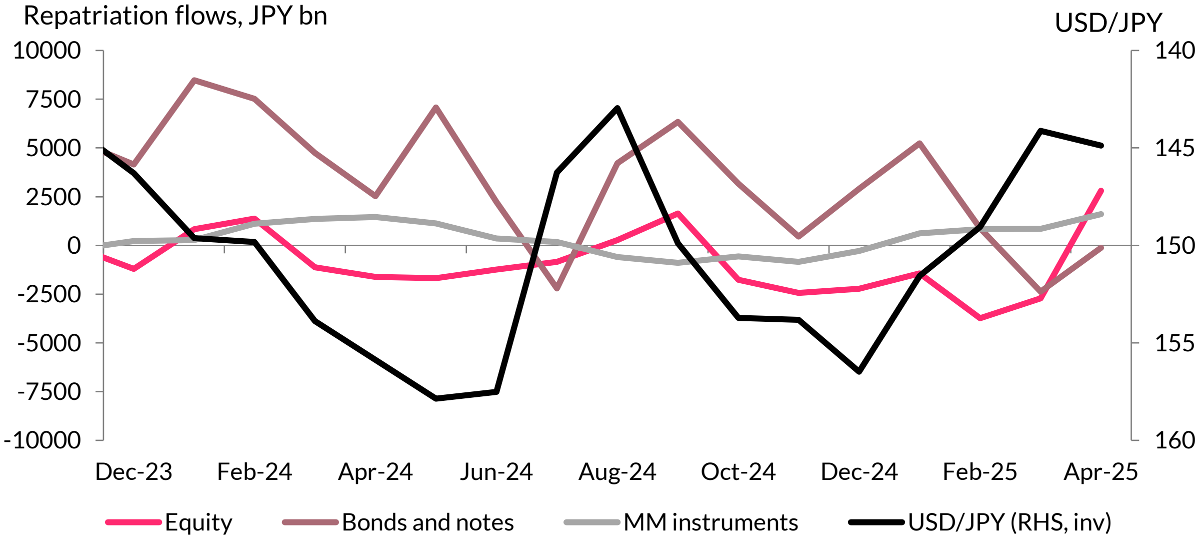
Since early March, the yen has strengthened by about 3.5% against the USD. In response to the stronger yen, Japanese investors have increased their purchases of foreign assets, partially reversing some of the yen's gains and reducing repatriation flows (Figure 8). This illustrates a feedback loop between yen strength and capital repatriation.

We expect USD/JPY levels to support incremental (but orderly) flows of capital back to Japan. This trend is likely to continue for the following reasons:

- In the medium term, we anticipate the yen will remain resilient against the dollar. Year-to-date, the yen has appreciated by 8% versus the USD, driven by (1) the BoJ's ongoing rate-hiking cycle and (2) risk-off sentiment. Looking ahead, we expect a shift toward a more risk-on market attitude, alongside resilient U.S. economic momentum and gradually rising Japanese yields.
- In the short term, speculative positioning remains long on the yen, indicating moderate market bullishness (Figure 9). This contrasts with 2022, when speculative positioning was heavily short on the yen, an environment that supported large repatriation inflows.

Figure 8

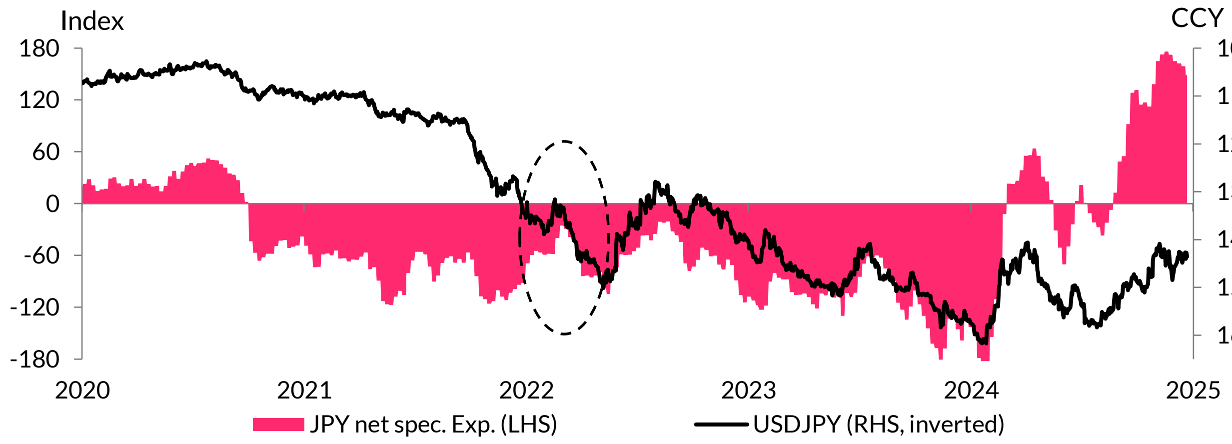
Yen gains tend to reduce repatriation flows by making them unprofitable



Source: Bloomberg, Japanese MOF, ANIMA Research

Figure 9

JGBs are more attractive than FX-hedged foreign bonds



Source: Bloomberg, ANIMA Research

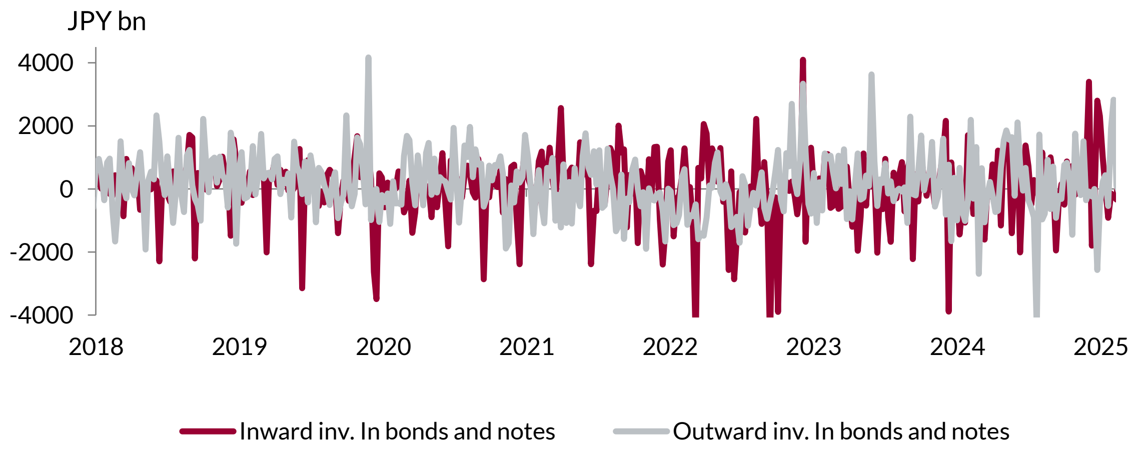
iii. Market sentiment has improved

Historically, episodes of capital repatriation have been preceded by a deterioration in market sentiment and a surge in volatility in foreign bond markets, particularly U.S. Treasuries (and occasionally other bond markets). These spikes in volatility typically triggered a flight to safety, prompting Japanese investors to sell large amounts of foreign bonds.

In April, immediately following Liberation Day, appetite toward U.S. assets worsened significantly, resulting in widespread selling of foreign bonds by Japanese investors. Since then, bond market volatility has declined considerably, and outflows from foreign bonds have reversed in May (Figure 10).

Figure 10

Japanese investors' outflows from foreign bonds reversed in May



Source: Bloomberg, Japanese MOF, ANIMA Research

At present, only two of the three necessary conditions (the first and second) are met; therefore, we do not expect a repeat of the 2022 episode.

To conclude

Overall, we do not see a case for an uncontrolled rise in JGB yields that could spill over and create instability in other bond markets through the financial stability channel, debt sustainability concerns, or repatriation flows.

ANIMA INVESTMENT RESEARCH

FABIO FOIS
Head of Investment Research & Advisory
fabio.fois@animasgr.it

CHIARA CREMONESI
Senior Rates Strategist
chiara.cremonesi@animasgr.it

FRANCESCO PONZANO
Junior Equity Strategist
francesco.ponzano@animasgr.it

VALERIO CEOLONI
Senior EM/FX Strategist
valerio.ceoloni@animasgr.it

MATTEO GALLONE
Junior Macroeconomist
matteo.gallone@animasgr.it

COSIMO RECCHIA
Senior Equity Strategist
cosimo.recchia@animasgr.it